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"The process of contraction, like the process of expansion, is cumulative and self-reinforcing. Once started, no matter how, there is a tendency for it to go on, even if the force by which it was provoked has in the meantime ceased to operate."

Prosperity and Depression, Gottfried Haberler
P. 323, London 1964, Original Edition 1937.

HIGHLIGHTS

This letter bears the title, Ameroscleroris. The expression, of course, is borrowed from the formerly popular catchword, "Eurosclerosis", which suggested a deep-seated secular loss of growth potential. It now applies to America. At issue, presently, are the causes of the obvious U.S. downturn. Their identification provides insight into the depth and length of the unfolding U.S. recession.

Most economists fail to understand the nature of the current U.S. business downturn. That blindness to the gravity of the present situation is really an outflow of the traditional Anglo-Saxon economics that has come to the fore over the past 80 to 90 years.

The unfolding U.S. recession is not caused by tight money or tight bank reserves. The causes all spring from one and the same source: the prior unprecedented credit boom.

Basically, two maladjustments together form the most potent combination of contractive forces impacting the U.S. economy since the Great Depression of the 1930s: a serious corrosion of the U.S. economy's growth potential and an unprecedented build-up of non-productive debt.

The forces that are presently depressing the Anglo-Saxon economies — budget deficits, trade deficits, overconsumption, under-saving, under-investment, over-indebtedness, and collapsing asset price inflation — simply have no place in the customary business cycle models.

Clinging to the sole navigational instrument of a "typical cycle", the majority — including the government and the Fed — take for granted that a monetary easing will promptly stimulate the economy back to vigour as always. This time it won't work.

Nevertheless, popular focus remains fixed on the regular cyclical accessories of a recession that financial markets love: cooling inflation and falling interest rates. Recession fear has quickly warped into "recession euphoria."

The impetus to an unfolding U.S. debt crisis is that rising incomes and cash flows are no longer materializing. Rapidly deteriorating debt-to-income and debt-to-asset ratios are on the verge of propelling the U.S. financial system into a deflationary vortex.

The massive economic and financial maladjustments that have accumulated during the past upswing argue that the U.S. economy is entering its deepest and longest recession since the 1930s. It will last a period of years and has only just begun to gather momentum.

AMEROSCLEROSIS

It is a fact that the great majority of American economists have been at a complete loss to understand why the U.S. economy should be heading for a recession, never mind a deep and prolonged slump. Though the incoming economic data now indisputably reveal an economy that is virtually plunging, the professionals cling unflinchingly to the belief that it's a case of nothing worse than a mini-recession — the "short and shallow" so to speak.

Stunned by the increasing gloominess of incipient economic news, the forecasters have scurried out lower forecasts. Now, recession is suddenly the consensus forecast with many economists admitting that it has already started. While it is now difficult to refute the evidence of a business downturn, rest assured they maintain, the recession they finally foresee is more of a statistical artifact than of any real gravity.

The November consensus of 52 top forecasters compiled by Blue Chip Indicators calls for real GNP to dip at an annual rate of 0.8% this quarter and 0.6% in the first quarter of 1991. The dark fog couldn't lift sooner though. Immediately thereafter, the consensus sees the economy taking off again towards a growth path of 2% and higher. If the consensus is correct, it would be by far one of the shortest and shallowest recession of the postwar period.

Remarkably, the international Organization for Economic Coordination and Development (OECD) strikes a similarly fawning pose over the U.S. economy in its annual report. The agency predicts that the total output of goods and services will decline at an annual rate of 0.4% in the current quarter and then rise at a 1.2% annual rate in the first half of next year, most of the acceleration occurring in the second quarter.

In short, the lulling message of professional American economists is not to worry . . . a lullaby of a nice, sweet, tinkling recession in the short run, followed by the purr of unhampered growth over the longer run. After all, the recession will be over before it has really started.

RECESSION FEAR TURNS INTO RECESSION EUPHORIA

Pretty much the same picture of underlying optimism emerges from recent surveys of professional money managers (particularly see Barron's of December 3, 1990). Many pay token homage to the unexpected economic weakness and certain so-called "long-term" problems like the large budget deficit, financial woes, and grossly insufficient savings. But, at end of all these acknowledgements they remain impatient "bulls" both on the economy and the stock market. Completely circumventing the possibility that the economic downturn might gather momentum, their eyes are glued on the regular cyclical accessories of a recession that they love: cooling inflation and falling interest rates that launch new bull markets in bonds and stocks. Recession fear has quickly warped into "recession euphoria."

Really, what is it that makes all these American economists and money managers so sure and stridently complacent? Essentially, the answer to that question lies in the reasoning behind the optimistic economic forecasts . . . and we hasten to add that the reasoning is exactly uniform whether it comes from governors of the Federal Reserve Board, the OECD, professional economists or the media.

We have read dozens of reports and statements commenting on the threat of a U.S. recession. Without exception, they all put forward the same three arguments why a meaningful recession is impossible: first, absence of the excess inventory build-up that typically deepens recessions; second, no sign of escalating inflation; and third, the consequent absence of a monetary tightening — in fact, to the contrary, the Fed is actually easing. In other words, to quote a Fed governor: "*None of the classic signs of recession are in sight.*"

Another argument generally advanced is that the "cheap" dollar, given continued strong growth in the rest of the world, should help U.S. exporters to keep their plants going even if domestic demand drops. In short, these forecasters are looking for a repeat of the export boom of 1988-89.

On final analysis, however, this stubborn optimism about a "short and shallow" recession rests mainly on slender strands of faith. The first is the belief that the Fed — being keenly aware of the debt and banking problems — is on guard to prevent a serious recession and, if push comes to shove, can readily resuscitate the economy by a more aggressive easing. Second is the faith in the resilience of the U.S. economy to withstand debt calamities, bank failures, oil shocks and turbulent financial markets. In sum, the record peace-time longevity of the expansion has created an unprecedented sense of security and an overestimation of the Fed's capability to steer the economy.

In our view, though, there is more behind this facade of complacency than just wishful or negligent thinking. This complete inability of most American economists to waken up to the gravity of the present situation is really the product of the traditional American economics that has come to the forefront over the past eighty to ninety years.

HAMSTRUNG BY A DIFFERENT THEORETICAL BACKGROUND

Probably unbeknownst to most people, there is a deep fundamental difference in economic thinking between American — or more precisely, Anglo-Saxon — and Continental European economists, meaning those mainly brought up in the Austrian/German tradition.

The key differences are twofold. One concerns the relationship between theory and statistics and the other relates to the role of capital formation and consumption in the economic process.

Austrian/German economics is a blend of long-term growth theory and cyclical statistical research. The focus is on understanding causal relationships in the economic process. American economics, to an ever increasing extent on the other hand, has turned away from the theoretical towards a purely statistical cyclical approach. That drift already started before World War I. Depending extensively upon statistical studies, American economics has ever increasingly exhausted itself in looking for "typical" correlations between statistical aggregates.

The second key difference between American and Austrian/German economics, as already mentioned, pertains to the conception of what determines an economy's rate of long-term growth. American economic policy, guided by the consensus opinion among American economists, for decades — actually since the 1920s — has aimed at boosting consumption as a means of stimulating growth and assumed that investment would then take care of itself. American growth theory, in other words, boils down to consumption theory. By contrast, the traditional Austrian/German growth theory centres on capital

theory and the axiom that per capita economic growth and prosperity depends essentially on one thing: rising capital formation relative to output and employment. To this model, high consumption — that being tantamount to low savings — is the arch enemy of economic growth.

We should add that this gross neglect of long-term capital theory has had a long tradition in Anglo-Saxon economics. Actually, considerations of capital formation already disappeared from the picture during the past century, long before Keynes.

In our view, it is important to know this historical and theoretical background because it captures the explanation for the astonishing complacency of most American and Anglo-Saxon economists regarding the economic developments in their countries. The forces that are presently depressing their economies — budget deficits, trade deficits, overconsumption, under-saving, under-investment, over-indebtedness, and collapsing asset price inflation — simply have no place in their customary business cycle models.

The bizarre result of this simplistic short-term thinking is that virtually every single major affliction depressing the U.S. economy over the longer run is being ignored. It's like a doctor who knows no other illness than pneumonia and pronounces everyone who doesn't have it as healthy.

A MILD RECESSION VERSUS A DEEP, PROLONGED CRISIS

At question is what factors or elements over-ride the case for a mild recession and instead point to a more deeper and prolonged economic crisis in the United States? The short-form answer is this: the previous, unusually long, debt-fuelled upswing has distorted and imbalanced the U.S. economic and financial structures as never before. This point is so important that we need to expand upon it further.

In our view — which is in sharp fundamental contrast with that of the consensus — the U.S. economy is presently exposed to the most powerful combination of recessionary forces since the Great Depression of the 1930s. The depressive forces are much more of a structural origin than cyclical.

In the first place, it has yet to be generally realized that the U.S. economy's potential to grow has suffered serious damage over the past years, undermining future productivity and income growth.

MORE CONSUMPTION AT THE EXPENSE OF INVESTMENT

Our task is to identify the set of forces that have ravaged the U.S. economy's long-term growth potential and set up the stage for long-term stagflation and financial crisis.

A quote of an old French economist, Guyot, sets the tone for our analysis. Back in 1984 he opined: "*Commercial and financial crises are produced, not by over-production, but by over-consumption.*" We must start with the recognition of the fact that the long U.S. economic upswing since the end of 1982 has entailed a dramatic transformation of the economy's whole production and capital structure. It was the most ill-structured upswing that the U.S. economy has ever experienced. Prolonged over-spending on consumption had its counterpart in prolonged under-saving and under-investment. As a result, the growth potential of the economy over the longer-run has been curtailed by reduced capital formation.

At the root of this sapping of the future growth potential is the collapse of national saving levels, that

being primarily caused by persistently large government budget deficits and inordinately high consumer borrowing. Internally, the bottom-line effect of these major imbalances has been a massive change in the use of available resources away from investment toward consumption. And the external manifestation of this condition has been a chronic current-account deficit.

The clearly visible evidence of this corrosive process is the sharp, unsustainable rise in the GNP-share of consumption. Less easily visible, though, is the additional damage to the growth potential that has occurred through massive maladjustments in the investment mix. These structural maladjustments or deformations are of two main kinds. One is a drastic shift in the investment pattern toward services and consumer-related activity, above all office towers, supermarkets, hotels and the like, a large part of which must be regarded as malinvestments. The anecdotal evidence is strong here. Consider that over 45% of all office space in the U.S. and a third of all hotel rooms were constructed during the 1980s.

The second major investment deformation is a disproportionate shift from long-lived to short-lived assets which implies a shorter depreciation time-span. The net effect in this case is sharply lower net investment, or in other words, sharply slower growth of the nation's capital stock.

THE MAIN CASUALTY: MANUFACTURING

Now, we come to the most worrying part of this "negative" restructuring of the U.S. economy. The lamentable thing is that this shift has occurred mainly at the expense of the manufacturing sector and related real investments.

Capital stock growth for the factory sector as a whole has averaged only 0.8% per year since 1983, less than one fourth of the trend rate of manufacturing capital formation that prevailed over the preceding 32 years. (*For references see Special Economic Study by Morgan Stanley, June 28, 1990; The Restructuring of America, and Federal Reserve Bank of New York, April 27, 1989; Adjustment of U.S. External Imbalances*.)

Here we draw the crucial conclusion. Altogether, these structural maladjustments have persisted long enough and in such magnitude that the U.S. economy's long-term productive potential has been seriously impaired.

THE LONG RUN RAPIDLY BECOMES THE SHORT RUN

Among modern economists it has become customary to ignore long-run effects, the assumption obviously being that the "long run" means a far off future which is of no immediate concern. In reality, these so-called long-run effects have a nasty tendency of surfacing rather quickly as serious short-term problems.

The fact is that the ill-effects of these long-term maladjustments are already evident in the form of a long-running decline in U.S. productivity growth, sagging world competitiveness, and a waning U.S. living standard. Low savings and investment have exacted a heavy price in terms of the U.S. economy's productivity ever since the 1970s. Sadly, developments in the 1980s virtually guarantee a further erosion.

To properly frame the predicament now confronting the U.S. economy, one has to review the U.S

growth record of the post-war period. During 1948-1973, potential output grew by 3.9%. That growth rate was achieved through productivity growth of 2.3% and employment growth of 1.6%.

Following that period, throughout 1973-1980 productivity growth almost disappeared declining to an annual rate of 0.5%. In this case, primarily because of demographic factors, a steep increase in the labour force translated into employment growth of 2.5%. Taken together, these two elements added up to an average annual growth rate of 3% for the economy.

During the 1980s, the annual growth rate again averaged about 3%; productivity gains contributing 1% and employment growth 2%.

Now, what about the 1990s? Given the prolonged and acute shortage of savings and net manufacturing investment, it seems a safe bet that the U.S. economy's productivity growth potential has fallen even below 1% per year. What's worse this time is that this loss in productivity potential now coincides with a sharp demographic-driven downturn in the labour-force growth rate to barely 1%. Combining the possible productivity growth and employment gains, it becomes clear that the U.S. economy's future long-term growth potential may well have shrunk to an annual rate of barely 2%.

Besides the obvious implications, imagine what problems such a low secular growth ceiling now presents. An economic backdrop like that would greatly exacerbate the problems of the federal budget and economy-wide over-indebtedness. One should remember that the much-ballyhooed budget agreement recently was dependent on the assumption that economic growth would average 3.8% a year from 1992 to 1995 and that short-term interest rates would fall to 5%.

Yet, all this only explains why America is condemned to a falling living standard. However, it does not explain the mechanics of why the U.S. economy is destined for a deep, prolonged crisis, both economic and financial. That has an additional reason: the borrowing binge of the 1980s and the particular uses to which the credit excesses were applied.

The salient fact, in the last analysis, is that the resulting credit and debt orgy of the 1980s unilaterally boosted private consumption. While the consumer borrowed unprecedented amounts, he was enriched even faster through the seemingly boundless wealth effects caused by corporate debt-leveraging and soaring government debts. The consumer got richer and richer — at least on paper — even though he spent more than his current income.

THE LEGACY OF VOODOO ECONOMICS

Here we have the explanation of how and why consumption expanded at the expense of investment. It was really "voodoo" economics made possible by the unrestrained use of the wonder drug "credit inflation" (by which is meant a credit expansion far in excess of available domestic savings.) It was made possible by an unrestrained domestic and internationally-financed credit boom.

Right from the beginning, though, there was a snag. The floods of inflationary credit found a myriad of different outlets including commercial and residential real estate, instalment credit, home equity loans, imports, takeovers, and leveraged buy-outs. However, the flood left the most important outlet high and dry: the financing of productive investment. Businesses jumped into debt as never before, but purely

for financial purposes and added nothing to the nation's capital stock.

Still, that raises one big question: Why? Why did it happen this way? That question immediately leads to the next: How will this extremely ill-structured expansion end? Will it end in a prolonged crisis as we think or in the more or less "soft landing" as most economists still believe?

THE KEY: PRICE-COST-PROFIT CONDITIONS

First of all, one has to start with this most important of questions: Why did the credit inflation not pump up investment spending, particularly manufacturing investment? The answer is simple and straightforward. The direction and extent of investment and production are always determined by relative prices and costs.

In the United States, the pipe furnishing industrial investment was clogged by adverse price-cost-profit conditions. Or, in more familiar language, manufacturing investment had been crowded out by high interest rates and an overvalued dollar which together squeezed business profits. New manufacturing investment has been the most unprofitable enterprise for the American businessman in the past ten years. The facts leave no doubt.

In absolute terms, manufacturing profit from domestic production is today (that being true even before the recession started) little higher than in the late 1970s and early 1980s while profit margins are near absolute lows. The reason is obvious. Manufacturing is the one sector of the economy that's fully exposed to foreign competition. And as an aside, this profit squeeze makes a sheer mockery of the view that the dollar is cheap and undervalued.

AND A DEBT CRISIS, TOO

Now, we come to the question of debt. During the past expansion, between late-1982 and mid-1990, total U.S. public and private indebtedness has risen from $4.7 trillion to $10.2 trillion, or by $5.5 trillion. At the same time, nominal GNP grew from $3.2 trillion to $5.5 trillion for a total of $3.3 trillion.

Is this past debt explosion of any relevance to the U.S. economy's future potential growth? For anyone with a modicum of common sense, that's not even a respectable question. Most American economists, however, who narrowly focus on the short-term business cycle tend to put this question aside as one of those unqualifiable long-term problems that don't bother them. Even the spectre of rapidly spreading loan-defaults only generates little interest, apparently on the assumption that the government and the Fed will take care of them, too. Happily, the result is that all debt, financial and banking problems are plainly left out of consideration.

The most important fact — and also entirely neglected for that matter — is that this pile-up of debt in the United States during the 1980s was incurred mostly for non-productive purposes. That kind of borrowing, though, has one doleful consequence. It raises present spending at the cost of future income and spending as interest payments gobble up a growing share of future income.

Inescapably and inevitably, there comes a point where interest payments propelled by the automatic pilot of compound interest overtakes new borrowing. Reckless borrowing and lending may postpone this day

of reckoning, but its ultimate arrival is axiomatic.

A TWO-FOLD DEBT SQUEEZE

Debts, no matter how high, are no problem as long as there is abundant new credit. Yet, there are limits to borrowing and lending. These limits are determined by income growth and the collateral values available to the borrowers.

The impetus to the unfolding U.S. debt crisis is that rising incomes and cash flows, which are required to service and pay-off past debts, are no longer materializing. Total corporate cash flows are already down in absolute terms. An average of 28% of cash flow is now soaked up by net interest payments comparing dismally with an 20% level as recently as 1988, according to Salomon Brothers. The consumer, on the other hand, has suffered zero growth in disposable personal income since early this year compared with growth of 2.5% in 1989 and 4.2% in 1988.

Though debtors may retrench, their debt-to-income and debt-to-cash flow ratios continue to deteriorate because income growth is slowing at an ever faster pace. That's only one aspect of the ongoing debt squeeze. There's another one at work.

Faced with shrinking income and/or cash flow, the debtor is increasingly forced to sell the assets that served as collateral for the loan credits. The increasing pressure of forced-asset divestitures pushes asset prices down. As grossly inflated collateral values collapse, attempted debt liquidations largely defeat themselves. A vicious circle of asset and debt deflation unfolds. Rapidly deteriorating debt-to-asset ratios join the rapidly deteriorating debt-to-income ratios in propelling the deflationary vortex downward.

For a perspective on what's happening to the spending power of the American consumer, we have to look at the two cumulating forces: current income growth and net new borrowing. During the past recovery, consumer spending was fuelled both by strong income growth and borrowing. After 1986, for tax reasons, the consumer's main debt excess centred in mortgages which more than doubled in the annual rate of increase to about $230 billion compared to the years before.

It has long been a favourite argument of American economists that sustained growth in service employment and consumer spending would prevent any recession. What has happened instead, is that both are in a virtual free fall and are in fact leading the economy into recession. What's more, it's happening in spite of the Fed's steady monetary easing. Like a chronic drug addict who needs ever higher dosages and whose veins have collapsed, the stimulative drug of credit inflation is losing its impact.

CONCLUSIONS FOR THE U.S. ECONOMY AND THE DOLLAR

This is the first and most important point to keep in mind: the unfolding U.S. recession is not caused by tight money, or more precisely, by tight bank reserves. Bank reserves have been ample all along prompting the banks to stampede into government paper. But, the credit window for the private sector remains nearly closed.

What then is the cause of this U.S. recession? There are two different branches of problems but both

spring from one and the same cause: virtually unlimited domestic and foreign credit, which by over-stretching the expansion, disrupted the economy's real and financial structure.

One key depressive influence, representing one of the problem branches, is rooted in the massive distortion of the demand and output structure of the economy. That distortion has been a function of two developments: firstly, an unsustainable, credit-inflated expansion in consumption, and secondly, a depletion of savings and investments which undermines productivity and income growth.

The second key depressive influence is embodied in the unprecedented debt and interest payment overload that has mortgaged future incomes and makes a debt and banking crisis a virtual inevitability. The handwriting is already on the wall. Collapsing real-estate collateral values and mushrooming problem loans force the banks to tighten their lending standards. Most remaining credit growth at this point probably reflects "distress borrowing" as desperate bankers try to hold their illiquid debtors above water because they can't afford to write off all the non-performing loans.

It's obviously clear to anyone that's not blind to the massive economic and financial maladjustments that have accumulated during the past upswing, that the U.S. economy is entering its deepest and longest recession since the 1930s. It will last a period of years and has only just begun to gather momentum, but, simply because the causes of this recession do not fit the standard of American business cycle textbooks, very few people recognize the seriousness of the situation.

Clinging to their sole navigational instrument of a "typical cycle", the majority — including the government and the Fed — take for granted that a monetary easing will promptly stimulate the economy back to vigour as always. It won't work this time.

Obviously, it is this illusion that still underpins the U.S. stock market and the U.S. currency. Their gradual declines so far, however, will give way to collapses as these complacent illusions burst.

GERMANY: THE STRIKING CONTRAST

The best way, probably, to get a comprehensive idea of how much the whole warp and woof of the U.S. economy has been impaired is to draw comparisons with the corresponding developments in Germany. While consumption and speculative paper profits were fuelled at the expense of capital formation and balance sheets in the United States, Germany's economic boom went in a diametrically opposite direction. It was a savings and investment boom.

The most visible achievements recently are the highest economic growth rate and the lowest inflation rate in the world. Real GNP of former West Germany expanded robustly in the third quarter to a level 5.5% above a year ago and at an annual rate of 8% (seasonally adjusted) over the second quarter. Industrial production was up 5.5% and 6.8%, respectively, and retail sales volume 11.9% and 33.4%. Employment rose 2.8%. Yet, consumer prices have increased only 3.0% against a year ago and producer prices have risen only 2.0%.

The continuing German boom is underpinned by factory investment (surging 13.5% over a year ago) and strong consumer demand bolstered by former East Germany. If it had not been for the latter, overall economic growth would certainly have been significantly lower. The phenomenal point, though, is that

economic growth would certainly have been significantly lower. The phenomenal point, though, is that the German economy was able to accommodate this burst of demand without jeopardizing internal price stability — thus defying the overwhelmingly pessimistic forecasts that German economic and monetary unification (Gemu) would boost inflation sharply.

Why have most international economist so utterly misjudged the developments in Germany? In short, for precisely the same reason they so grossly misjudged the developments in the United States. Brought up in the tradition of focusing on the business cycle and short-term demand management, they overlooked that the German economy, too, had undergone a similar restructuring but in a completely different direction.

Putting it in the words of Friedrich Hayek (of the Austrian School), Germany has sharply increased or lengthened its capital structure; America has sharply decreased and shortened its capital structure. What does that mean? Look at the two charts on the following page showing the development of savings in the United States and Germany. It's up in Germany and down in America.

Even more illuminating is the bottom table which provides greater detail on the development of German savings and investment.

A SUCCESSFUL GROWTH RECIPE

Recently, we read a comment in the Financial Times on Mrs. Thatcher's policies saying that five or six years are apparently not enough to transform an economy. That might be up for question. First of all, Mrs. Thatcher reigned more than 10 years, and secondly, the German experience actually proves otherwise.

GERMANY: INVESTMENT AND SAVINGS
(AS % OF NET NATIONAL PRODUCT)
* Inception of Kohl Government in 1982

	1980	*1982	1989
Real Investment	%	%	%
Business Sector	**10.0**	**5.8**	**8.8**
Machinery and Equipment	5.0	1.5	5.7
Construction	4.7	3.9	2.9
Financial Institutions	0.3	0.3	0.2
Public Sector	**3.4**	**2.4**	**1.9**
Net Foreign Claims	**-2.1**	**0.6**	**4.9**
Total Investment	**11.3**	**8.8**	**15.6**
Savings			
Personal Savings	**8.2**	**8.3**	**7.5**
Corporate Savings	**3.0**	**1.8**	**6.0**
Production	1.1	-0.5	3.7
Construction	0.3	0.8	1.3
Financial Institutions	1.6	1.5	1.0
Public Sector	**0.1**	**-1.3**	**2.1**
Total Savings	**11.3**	**8.8**	**15.6**

Source: German Bundesbank

In 1982, the Kohl government took over a badly weakened economy denoted by an inflation rate of over 5%, a record budget deficit, a current account deficit, and record low business profits and investments.

In the following years, all of these maladjustments were thoroughly corrected. How was it done?

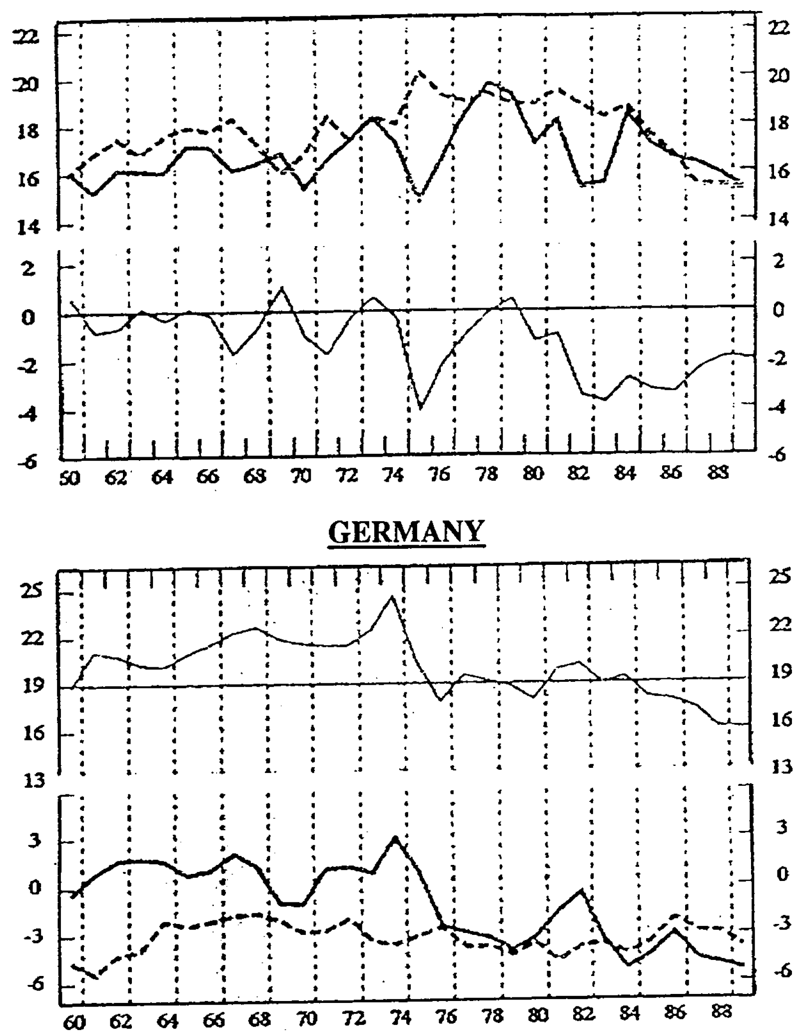
Before heaping praise on the German government and the Bundesbank, the first credit really goes to the German consumer who stubbornly saved 14% of his income during this period. Here, the crucially important changes occurred in budget policy and wage policy.

Basically, it was nothing more than good old fashion economics. The guiding idea was shaped by the recognition that the allocation of resources needed to shift away from public consumption towards investment — that being complemented by an income redistribution favourable to investment profitability.

Developments in Private Saving and Investment and Govt. Net Saving

(As a percentage of GNP, in current Prices)

UNITED STATES



▬ Private Investment ——— Government Net Saving ---- Private Saving

Source: Development in External and Internal Imbalances, Bank for International Settlements, Basle. Economic Paper Nr. 29.

Rigorous public spending restraints were aimed at two important effects: reduction in capital costs as well as a release of resources for investment. This fiscal strategy was complemented by a moderation in wage increases. After years of wage inflation, German wage unions consented to wage raises below the combined rate of productivity growth and inflation.

Compared with the noise made by Reaganomics and Thatcherism, it looked like an extremely tame policy. Few people, even in Germany, realized how dramatically the German economy was to be transformed.

Within less than eight years, the budget deficit had disappeared and public spending had fallen from nearly 52% of GNP to a level of 46.5%. No less dramatic was the attendant income redistribution that

resulted due to ongoing wage moderation. Business profits soared from 18.8% of national income in 1981 to 26.9% in 1989 while the share of wages plunged from 74.4% to 67.2% of national income. These new profit and wage ratios were again the same as in the 1960s.

The final outcome was a drastically restructured economy as illustrated by the table on page 10. Moderate increases in public and private consumption had their counterpart in a savings, investment and export boom with investment being stimulated by a boom in business profits, which, in absolute amounts, doubled between 1980 and 1989.

SUMMARY CONCLUSIONS

The world has been slow to realize that all the debt-laden deficit countries are on the verge of a deep, prolonged recession. It is the inevitable and natural result of irresponsible policies that relied on limitless borrowing. For the time being, worries of inflation and currency weakness restrain them from an aggressive monetary easing. So far, it's only the first stage downturn. As it gathers momentum, recession-fighting will take on top priority, setting the stage for a drastic weakening of the deficit-country currencies.

Similarly, the world has been slow to realize that when viewed against the background of a world recession, the necessity to rebuild East Germany is not a burden, but is rather an opportunity that lends support to the German and European economy.

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